

**SENATE FISCAL AGENCY
MEMORANDUM**



DATE: July 28, 2005

TO: Members of the Senate Transportation Subcommittee
Senator Shirley Johnson, Chair
Senator Tony Stamas
Senator Jim Barcia

FROM: Craig Thiel, Fiscal Analyst

RE: Comprehensive Transportation Fund Revenue Diversions

As the Legislature moves toward completion of the fiscal year (FY) 2005-06 State General Fund budget, one area of revenue used to balance previous years' budgets has been the Comprehensive Transportation Fund (CTF). This memo describes how much CTF revenue has been diverted over the past four years to help the General Fund and the impacts of such diversions.

Overview

The Comprehensive Transportation Fund is created in Section 10b of Public Act 51 of 1951 to provide operating and capital funding for various public and freight transportation programs. The CTF receives State revenue from two primary sources, the Michigan Transportation Fund (MTF) and a portion of the State sales tax on motor vehicle related sales. The Fund also receives State revenue from licenses, permits, interest earnings, and miscellaneous sources. In FY 2000-01, total State CTF revenue was \$237.5 million. Recent revenue estimates for FY 2004-05 project CTF revenue at \$225.2 million. Despite an increase in both total MTF and total State sales tax revenue since FY 2000-01, actual CTF revenue has declined 5.2%. The reason for this decline is directly related to efforts to balance the State's General Fund budget with revenue that traditionally went to the CTF. Specifically, since FY 2000-01, \$65.1 million of CTF revenue has been diverted, directly or indirectly, to help General Fund budget items.

Two Sources of Revenue

Article IX, Section 9 of the Michigan Constitution allows up to 10% of the specific taxes, except general sales and use taxes and regulatory fees, imposed directly or indirectly on fuels sold or used to propel motor vehicles upon highways and on registered motor vehicles, after payment of necessary collection expenses, to be used for comprehensive transportation purposes. These transportation taxes are deposited in the Michigan Transportation Fund under Michigan law. Section 10 of Public Act (P.A.) 51 of 1951 requires that 10% of MTF revenue, after certain statutory earmarks, to be transferred to the CTF. The largest earmark of MTF revenue, prior to the CTF distribution, is four cents of the State gasoline tax, estimated to be \$196.8 million in FY 2004-05¹. As a result of these statutory earmarks, the CTF's effective share of MTF revenue in

¹ In addition to earmarking 4 cents of the gasoline tax, Section 10 of PA 51 distributes funding for collection and administrative costs (\$45.5 million in FY 2004-05), \$3 million to the rail grade crossing account, not less than \$3 million for Critical Bridge Fund debt service, and \$43 million for State Trunkline Fund debt service, prior to the CTF distribution.

FY 2004-05 is estimated to be 8.5%, about \$29.1 million less than the constitutional limit of 10%.

The CTF also receives a share of State sales tax collections on certain purchases of fuel and automotive items. Article IX, Section 9 also allows not more than 25% of the State sales tax revenue from motor vehicle related sales, after payment of necessary collection expenses, to be used for comprehensive transportation purposes. Current law allows the State to collect a sales tax of 6% on certain purchases of motor fuel, automobiles, and automotive related items, such as replacement parts and accessories. One-third of the revenue (2 percentage points of the 6% tax) is directly distributed to the School Aid Fund, as required by Article IX, Section 8 of the Michigan Constitution. The revenue from the 4% sales tax on motor vehicle related sales is distributed to the School Aid Fund (60%), local government revenue sharing payments (15%), the CTF (6%), and the remainder to the General Fund (19%)². Table 1 lists State CTF revenue by source for the period FY 2000-01 through FY 2004-05.

Table 1

Comprehensive Transportation Fund Revenue (millions of dollars)					
	<u>FY 2000-01</u>	<u>FY 2001-02</u>	<u>FY 2002-03</u>	<u>FY 2003-04</u>	<u>FY 2004-05*</u>
MTF Revenue	\$159.2	\$159.8	\$162.3	\$166.3	\$168.6
Sales Tax Revenue	73.7	66.1	79.4	65.0	55.3
Other Revenue	4.6	2.2	4.6	4.4	1.3
Total	\$237.5	\$228.1	\$246.3	\$235.7	\$225.2

* Estimate as of May 2005

Source: MDOT, Comprehensive Annual Financial Report

Despite the fact that total MTF revenue and total auto related sales tax revenue have increased over the past five years, total CTF revenue has declined. During the five-year period, total MTF revenue increased from \$1,913.5 million to \$1,995.8 million, or 4.3%. Table 1 shows that the CTF portion of the MTF correspondingly increased by 5.9% during this period³. During the same period, total auto related sales tax revenue increased from \$1,053.3 million to \$1,088.2 million, or 3.3%. However, as Table 1 displays, sales tax revenue earmarked to the CTF declined by 25.0% over the past five years and as a result total CTF revenue declined 5.2%.

CTF Revenue Diversions

The reason for the CTF revenue decline during the past five years is directly related to efforts to balance the overall State budget with a portion of the revenue traditionally dedicated for transportation purposes. It is estimated that over \$65.1 million in total CTF revenue (a combination of State sales tax and MTF revenue) has been diverted, directly or indirectly, to the General Fund since FY 2000-01. Whereas all motor fuel and vehicle registration tax revenue deposited in the MTF, including the portion earmarked for the CTF, is constitutionally restricted for transportation purposes, the sales tax revenue deposited in the CTF is statutorily earmarked and the entire amount can be redirected to support the General Fund budget.

² Specifically, Section 25 of the General Sales Tax Act allows not less than 24% of 25%, or 6%, of motor vehicle related sales tax revenue to go to the CTF.

³ The reason for the difference between the two growth rates has to do with the amount of MTF interdepartmental grants appropriated in FY 2000-01 (\$50.3 million) and in FY 2004-05 (\$29.0 million) and the impact that the PA 51 formula has on CTF revenue.

Since FY 2001-02, \$45.5 million of sales tax revenue traditionally earmarked to the CTF has been channeled to the General Fund, through changes to Section 25 of the General Sales Tax Act. The first change to Section 25 occurred in Executive Order 2001-9, which reduced the amount of sales tax revenue deposited in the CTF by \$12.75 million and transferred this revenue to the General Fund for FY 2001-02⁴. Table 2 lists the various CTF revenue diversions since FY 2001-02 intended to aid the General Fund budget, either directly or indirectly.

Table 2

Comprehensive Transportation Fund Revenue Diversions				
(millions of dollars)				
	<u>FY 2001-02</u>	<u>FY 2002-03</u>	<u>FY 2003-04</u>	<u>FY 2004-05</u>
Executive Order 2001-9	(\$17.6)	(\$4.8)		
P.A. 151 of 2003			(10.0)	
P.A. 139 of 2003			(10.8)	(10.9)
P.A. 544 of 2004				(10.0)
House Bill 4082*				(1.1)
Total	(\$17.6)	(\$4.8)	(\$20.8)	(\$22.0)

* Based on House-passed version (H-4).

Public Act 139 of 2003 reduced the percentage of revenue from the 4% sales tax on auto related sales that is deposited in the CTF from 7% to 6% for a two-year period, FY 2003-04 and FY 2004-05. Based on actual sales tax revenue figures for FY 2003-04, P.A. 139 reduced CTF revenue by \$10.8 million and increased General Fund revenue by the same amount. For FY 2004-05, the rate reduction is expected to decrease CTF revenue by \$10.9 million and increase General Fund revenue by the same amount. It is worth noting that the Governor's FY 2005-06 budget recommendation is based on statutory changes that would continue this diversion.

Public Act 544 of 2004 further reduced the amount of sales tax revenue deposited in the CTF by a flat \$10.0 million for FY 2004-05 and increased General Fund revenue by the same amount.

In addition to the sales tax revenue diversions, the CTF has experienced reduced MTF allocations as a means to help balance the General Fund budget and to support highway capacity improvement projects. First, Executive Order 2001-9 increased the MTF grants to the Departments of State and Treasury by a total of \$48.0 million and reduced General Fund appropriations in these departments by a corresponding amount⁵. This funding shift effectively reduced the amount of MTF revenue deposited in the CTF by \$4.8 million in FY 2001-02. This funding shift continued in the next fiscal year, costing the CTF another \$4.8 million in MTF revenue in FY 2002-03⁶.

⁴ In 2002, the County Road Association of Michigan (CRAM) sued the State of Michigan over the constitutionality of this transfer. In 2002, the trial court enjoined the transfer of CTF funds to the General Fund. In 2003, the Court of Appeals upheld the constitutionality of the transfer. Plaintiffs have sought Application for Leave to Appeal to the Michigan Supreme Court and reverse the decision of the Court of Appeals.

⁵ Traditionally, these grants are set in annual appropriation bills. In FY 1996-97, MTF grants to all agencies totaled \$90.3 million. These grants were reduced to about \$48.0 million annually between FY 1997-98 and FY 2000-01, before being doubled to \$95.7 million under Executive Order 2001-9.

⁶ The FY 2002-03 MTF grant to the Department of State was \$87.9 million. In 2003, the MTF grant to the Department of State was statutorily capped at \$20 million per fiscal year, beginning in FY 2003-04.

Second, as part of the MTF revenue enhancement package in 2003, the State changed the registration cycle for trailers from an annual basis to a one-time basis⁷. The package of legislation resulted in a one-time MTF revenue increase of \$108.0 million. However, this legislation diverted \$10.0 million of the CTF's portion of the revenue increase (\$10.8 million) to the State Trunkline Fund for highway capacity improvement projects.

Third, as part of the FY 2004-05 General Fund budget solution, GF/GP appropriations to the Department of State were reduced by \$10.6 million under Executive Order 2005-7 and replaced with restricted revenue appropriations under P.A. 11 of 2005. House Bill 4082 would transfer approximately \$10.5 from the MTF to satisfy the restricted revenue appropriations contained in P.A. 11. This funding shift effectively reduces CTF revenue in FY 2004-05 by \$1.1 million. The Governor's FY 2005-06 budget assumes that this would be a permanent revenue shift, costing the CTF another \$1.1 million.

Impacts of Revenue Diversions

State CTF revenue is used to support a variety of public and freight transportation programs, which receive funding through the annual MDOT budget⁸. The first priority of this revenue, as set forth in P.A. 51 of 1951, is to pay principal and interest on outstanding CTF debt, which is approximately \$28.5 million in the current year. The second priority is the payment of MDOT's costs associated with administering the CTF, which is approximately \$8.3 million this year. The third priority and the largest use of this revenue by far, is the annual operating assistance grants provided to local public transit agencies. Over two-thirds of the total appropriated CTF revenue, \$161.7 million, is budgeted for this purpose in FY 2004-05. The remainder of available CTF revenue is reserved for public transportation purposes as described in P.A. 51. In some cases, P.A. 51 establishes minimum funding levels for select public transportation programs⁹. It is estimated that \$194.5 million in CTF revenue in FY 2004-05 is needed to satisfy these three priorities and the minimums set in P.A. 51.

Beginning with Executive Order 2001-9, the series of CTF revenue reductions listed above required appropriation reductions to bring spending in line with revenue availability each year. For the most part, CTF program cuts have focused on discretionary funding, i.e., those programs not listed as "priority" or that do not have a "funding floor". The FY 2004-05 budget reduced or eliminated funding for many of these programs. Table 3 shows CTF appropriations in FY 2003-04 compared with FY 2004-05 for CTF-funded programs and the changes resulting from recent budget cuts. Continued revenue reductions will force further cuts to or eliminations of discretionary programs in order to meet P.A. 51 priorities and minimums. It is worth noting that the CTF revenue decline has resulted in the current-year budget not meeting the P.A. 51 funding requirements for the Intercity Passenger and Freight Program, which is 10% of the CTF¹⁰.

⁷ Enrolled Senate Bill 539 (PA 151 of 2003) and Enrolled Senate Bill 554 (PA 152 of 2003).

⁸ In addition to annual appropriated State CTF revenue, MDOT uses CTF bond proceeds to fund various transportation programs, mostly capital projects. This money, however, is not included in the annual MDOT budget.

⁹ For example, PA 51 requires that each transit agency annually shall receive at least the amount of CTF revenue they received in FY 1996-97 for local bus operating assistance grants, which amounts to \$121.3 million.

¹⁰ CTF funding for this program totals \$16.3 million, about \$6.2 million below the PA 51 floor.

Table 3

CTF-Funded Programs in MDOT Budget (CTF amount in millions of dollars)			
Program	FY 2003-04	FY 2004-05	Change
Debt Service	\$28.7	\$28.5	(\$0.2)
Administration	5.0	5.5	0.5
Grants to Other Agencies	3.0	3.1	0.1
Bus Operating Grants	161.7	161.7	0
Bus Capital	14.5	8.0	(6.5)
Intercity Passenger & Freight Programs	21.0	16.3	(4.7)
Public Transportation Development Programs	12.5	9.2	(3.3)
Total	\$246.3	\$232.3*	(\$14.0)

*At this level, the CTF budget is out of balance by approximately \$7.0 million. The State Budget Office has indicated that appropriation allotments have been reduced to bring spending into alignment with projected revenue of \$225.2 million.

Despite the large share of CTF funding directed to the program, appropriations for local bus operating assistance grants have remained fairly constant the past three fiscal years and have avoided requisite budget cuts. The FY 2004-05 appropriation remains \$40.4 million above the P.A. 51 "floor" for these grants. Although protected from hard budget cuts, the CTF revenue diversions have impacted the State operating grants indirectly. Stagnant State funding means that local agencies will have to tap other funding sources to maintain budgets or face service reductions. Transit providers will be forced to address the rising operational costs (e.g., fuel, health care, etc.) they are facing with revenue from increased local sources or fares. State reimbursement rates, as a percentage of total operating costs, have declined significantly during the period FY 2000-01 to FY 2004-05. During this time, the urban systems' reimbursement rate has gone from 38.1% to 32.4% while the other systems' rate has dropped from 45.5% to 38.4%¹¹. Given the current State funding environment, it is unlikely that local agencies will be able to expand local bus service without additional State CTF assistance. Most likely, agencies will focus on providing the status quo service level before considering expanded service.

While State funding for operational grants has not been affected, State support for local bus capital projects has been cut. For example, the FY 2004-05 budget reduced the appropriation used to match Federal funds for local bus capital to the P.A. 51 "floor" of \$8.0 million from \$14.5 million in FY 2003-04 (see [Table 3](#)). Traditionally, MDOT has used CTF money to provide the full 20% non-Federal match for local bus capital projects (e.g., bus acquisitions, terminal projects, transit equipment)¹². Continued revenue reductions may prevent the State from being able to provide the entire portion of the non-Federal match for local bus capital projects. This could force local transit agencies, for the first time, to supply a portion of the non-Federal match from local sources of revenue. If local agencies are unable or unwilling to make up the shortfall in requisite matching funds, Federal capital funds could be forfeited.

¹¹ PA 51 requires the CTF to provide urban agencies (with a population greater than 100,000) with a grant of up to 50% of operating expenses and other agencies (population less than or equal to 100,000) with a grant of up to 60% of operating expenses.

¹² MDOT uses a combination of appropriated CTF revenue and CTF bond proceeds revenue to meet the non-Federal match.

Conclusion

As the Legislature continues to grapple with State revenue issues and the challenges of balancing the General Fund budget, it is likely that some portion of transportation revenue will be diverted to address other State priorities. Because constitutional restrictions prevent State fuel and vehicle registration taxes from being used for non-transportation purposes, the vast majority of State transportation revenue can not be diverted to address General Fund budget shortfalls. However, sales tax revenue that is used to support various public and freight transportation programs can be diverted to the General Fund. To date, over \$65.1 million in traditional CTF revenue has aided the General Fund budget. It is likely that CTF-funded programs will continue to be adversely impacted by the State's budget woes. For example, the FY 2005-06 budget recommendation includes a continuation of a reduction in CTF sales tax revenue (\$10.8 million), originally scheduled to end after FY 2004-05. Policymakers will not know immediately what the full impact of these CTF revenue diversions will mean to public and freight transportation services provided in Michigan. However, to date, a number of programs have been eliminated and services reduced.

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